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IN THE

Supreme Court of the United States

OCTOBER TERM 1934.

WILLIAM E. HERRING AND EULA DAY HERRING,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

On Writs of Certiorari to the United States Circuit Court of Appeals for the Fifth Circuit.

BRIEF FOR PETITIONERS.

Opinions Below.

The opinion of the Circuit Court of Appeals for the Fifth Circuit (Judge Sibley delivering a dissenting opinion) appears in the record on pages 37 to 46 and is reported in 70 F. (2d) 785. The opinion of the Board of Tax Appeals,

which was a memorandum opinion not officially reported, appears in the record at pages 13 and 14.

Jurisdiction.

The judgment of the Circuit Court of Appeals for the Fifth Circuit was entered April 24, 1934 (R. 46), petition for rehearing denied June 8, 1934 (R. 47), Writs of Certiorari were granted October 8, 1934. Jurisdiction is conferred upon this Court by Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

Question Presented.

In computing net taxable income for 1926 are the petitioners entitled to deduct the statutory allowance for depletion from the advance royalties or "bonuses" received by them in 1926 upon the execution in that year of ordinary oil and gas leases? Or must they lose that allowance because the land leased was not producing oil or gas when the leases were made, and because the land did not produce oil or gas until after 1926?

Statutes and Regulations Involved.

Section 214(a) 1926 Revenue Act.

> "In computing net income there shall be allowed as deductions:
>
> * * * * * * * *
>
> (9)In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In the case of leases the deduction allowed by this paragraph shall be equitably apportioned between the lessor and lessee;"

Section 204(c) 1926 Revenue Act.

"The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the same as is provided in subdivision (a) or (b) for the purpose of determining the gain or loss upon the sale or other disposition of such property, except that—

(1) In the case of mines discovered by the taxpayer after February 28, 1913, the basis for depletion shall be the fair market value of the property at the date of discovery or within thirty days thereafter, if such mines were not acquired as the result of purchase of a proven tract or lease, and if the fair market value of the property is materially disproportionate to the cost. The depletion allowance based on discovery value provided in this paragraph shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property upon which the discovery was made, except that in no case shall the depletion allowance be less than it would be if computed without reference to discovery value. Discoveries shall include minerals in commercial quantities contained within a vein or deposit discovered in an existing mine or mining tract by the taxpayer after February 28, 1913, if the vein or deposit thus discovered was not merely the uninterrupted extension of a continuing commercial vein or deposit already known to exist, and if the discovered minerals are of sufficient value and quantity that they could be separately mined and marketed at a profit.

(2) In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph.

Article 216, Regulations 69.

"*Depletion—Adjustments of accounts based on bonus or advanced royalty.*

"(a) [1] Where a lessor receives a bonus in addition to royalties, there shall be allowed as a depletion deduction in respect of the bonus an amount equal to that proportion of the cost or value of the property on the basic date which the amount of the bonus bears to the sum of the bonus and the royalties expected to be received. Such allowance shall be deducted from the amount remaining to be recovered by the lessor through depletion, and the remainder is recoverable through depletion deductions on the basis of royalties thereafter received.

* * * * * * * *

"(c) [2] If for any reason any such mineral lease shall be terminated or abandoned before the mineral which has been paid for in advance has been extracted and removed, and the lessor repossesses the leased property, the lessor shall adjust his capital accounts

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[1] Article 215(a) of Regulations 45 (1918 Act) read as follows:

"Where a lessor receives a bonus or other sum in addition to royalties, such bonus or other sum shall be regarded as a return of capital to the lessor, but only to the extent of the capital remaining to be recovered through depletion by the lessor at the date of lease. If the bonus exceeds the capital remaining to be recovered, the excess and all the royalties thereafter received will be income and not depletable. If the bonus is less than the capital remaining to be recovered by the lessor through depletion, the difference may be recovered through depletion deductions based on the royalties thereafter received. The bonus or other sum paid by the lessee for a lease made on or after March 1, 1913, will be his value for depletion as of date of acquisition."

Treasury Decision 3938, promulgated November 13, 1926, Internal Revenue Bulletin V-2, page 117, changed subdivision (a) to read as follows:

"Where a lessor receives a bonus in addition to royalties, there shall be allowed as a depletion deduction in respect of the bonus an amount equal to that proportion of the cost or value of the property on the basic date which the amount of the bonus bears to the sum of the bonus and the royalties expected to be received. Such allowance shall be deducted from the amount remaining to be recovered by the lessor through depletion, and the remainder is recoverable through depletion deductions on the basis of royalties thereafter received."

Murphy Oil Co. v. Burnet, 287 U. S. 299, dealt with subdivision (a) as originally promulgated and as amended.

[2] All regulations beginning with those under the 1918 Act have contained provisions identical with subsections (c) and (d).

by restoring to the capital sum of the property the depletion deductions made in prior years on account of royalties on mineral paid for but not removed, and his income account shall be adjusted so as to include the amount so restored to capital sum as income of the year such lease is terminated or the property repossessed, and the tax thereon paid.

"(d) Upon the expiration, termination, or abandonment of the lease, without the removal of any or all of the mineral contemplated by the lease, the lessor shall be required to restore to capital account the excess of the depletion theretofore allowable in respect of the bonus and royalty payments over the actual depletion or loss in value sustained as a result of the operations under the lease, and a corresponding amount must be returned as income for the year in which the lease expires, terminates, or is abandoned."

"(e) [1] In lieu of the treatment provided for in the above paragraphs the lessor of oil and gas wells may take as a depletion deduction in respect of any bonus, royalties, and other income from the property for the taxable year 27½ per cent of the amount thereof, but the deduction shall not exceed 50 per cent of the net income (computed without allowance for depletion) from the property."

Statement.

During the year 1926 the community estate of William E. Herring and his wife Eula Day Herring owned a 50 per cent interest in the partnership C. T. Herring & Son. For that year petitioner William E. Herring and his wife, petitioner Eula Day Herring, filed separate income tax returns under the community property laws of Texas. In 1926 the partnership owned a large tract of land in the vicinity of Amarillo, Texas, and its principal business was cattle raising. During 1926 the partnership leased portions of its land for the "sole and only purpose of mining and operat-

[1] This subsection was first introduced into the regulations under the 1926 Act, due to the option contained in that Act to compute oil and gas depletion by the "percentage" method.

ing for oil and gas," etc. These leases were in all respects the customary oil and gas leases (R. 30). The lessees paid in the aggregate to the partnership lessor, in 1926, $683,793.75 as advance royalties or bonuses and agreed to pay further royalties of 1/8th of the product, or its value, as oil or gas was actually produced under the leases.

The lessor had no control over the time wells would be drilled by the lessees. At the time the leases were executed and during the remainder of the year 1926 there was no oil or gas well on the land and no oil or gas was produced therefrom. However, in 1930 four wells were drilled, all of which were commercial gas wells, all had a showing of oil, and one produced from eight to ten barrels of oil a day.

In 1926, when the leases were executed, it was highly probable that the land would, when explored, produce oil or gas or both. This is shown in the record by the fact that wells comparatively close and on all sides of the property were producing; by uncontradicted expert testimony as to geological conditions and, perhaps more convincing to those who cannot qualify as technical oil and gas men, by the fact that the lessees, who were engaged in the oil and gas business, were willing to pay $683,793.75 for the privilege of exploring the property for oil and gas.

The partnership claimed its members were entitled to a deduction in 1926 on account of depletion in the aggregate amount of $188,043.28, which represented 27½ per cent of the advance royalties or bonus payments. Each of the present petitioners deducted from income on their income tax returns their proportionate share of the said depletion deduction claimed by the partnership. The Commissioner of Internal Revenue refused to allow the deduction on the ground that "the property on which depletion was claimed was neither proven nor producing during the year in question." The Board of Tax Appeals, in a memorandum opinion, affirmed the Commissioner on the authority of *Lizzie H. Glide*, 27 B. T. A. 1264, which held that there must be a well on the property before the lessor could be allowed the

depletion deduction. The Circuit Court of Appeals, Sibley, Circuit Judge, dissenting, affirmed the Board on the ground that there was no production on the property within the taxable year.

Specification of Errors to Be Urged.

1. The Court below erred in holding that advance royalties or bonuses are not subject to depletion.

2. The Court below erred in not holding that percentage depletion is based upon income, the allowance of which looks forward or backward to actual production.

3. The Court below erred in denying petitioners the reasonable allowance for depletion which the statute permits.

4. The Court below erred in affirming the Board of Tax Appeals.

Argument.

Decision should be for the petitioners for the following reasons:

1. The advance royalties are taxable income. *Burnet v. Harmel,* 287 U. S. 103; *Bankers Coal Co. v. Burnet,* 287 U. S. 309;

2. The advance royalties are not proceeds from the sale of property but payments in advance for oil and gas to be produced (*Murphy Oil Co. v. Burnet,* 287 U. S. 299; *Work v. Mosier,* 261 U. S. 352); therefore they come within the term "gross income from the property" as used in Sec. 204 (c) (2) of the Revenue Act of 1926—requiring that "percentage" depletion be allowed on such "gross income."

3. The right to the deduction is not defeated by the qualifying phrase "in the case of oil and gas wells". This phrase does not require either the existence of an oil or gas well when the lease is made, or later in the same year, nor production in that year. It is satisfied if, at any time

during the term of the lease, oil or gas is produced. This is so, because:

(a). This construction was placed upon the same language in prior Revenue Acts, and the language reenacted in the light of that construction. *United States v. Dakota-Montana Oil Co.,* 288 U. S. 459.

(b). Practice and rulings, under the same or similar language, permitted depletion with respect to advance royalties when no well was in existence during the year the lease was executed and the bonus was received, and when no oil or gas was produced in that year.

(c). This Court has expressly held that an allowance for depletion should be made with respect to advance royalties, and this without the qualifications which the Government now seeks to impose and uphold. *Murphy Oil Co. v. Burnet,* 287 U. S. 299.

(d). Treasury Regulations have, since 1918, provided for the recapture of all, or part, of such an allowance if the execution of the lease was not followed by actual production and exhaustion of the oil or gas content. This not only warrants the practice but prevents fiscal loss if no depletion is actually sustained.

(e). The allowance for "percentage depletion" is based upon receipt of income from the property in the tax year—not upon actual production and exhaustion in the tax year. Necessarily it must look forward or backward to actual production and exhaustion, but the requirement of contemporaneous production destroys the basic principle of percentage depletion.

(f). The theory of the Government in this case, and of the majority below, as well as the Board of Tax Appeals, is not the theory of the Treasury. This is expressed in G. C. M. 11384. It conflicts directly with the reasoning of the Government here. If G. C. M. 11384 is construed to deny Petitioners' claim, the result is so arbitrary and whimsical that even its more liberal theory must be enlarged to cover the situation herein presented.

In order to present a complete picture of the problem involved this brief presents a short history of the legislation allowing a deduction for depletion (p. 9), a discussion of the changes resulting from the adoption of percentage depletion in the case of oil and gas wells (p. 10) and a history of the taxation of advance royalties, or bonuses (p. 12).

History of legislation allowing a deduction for depletion.

The Excise Tax Act of 1909 (36 Stat. 11, 112) had no provision for depletion. Under that Act it was held that a deduction for depletion could not be taken as the right to such deduction is statutory. *Stratton's Independence v. Howbert,* 231 U. S. 399; *Von Baumbach v. Sargent Land Co.,* 242 U. S. 503; *United States v. Biwabik Mining Co.,* 247 U. S. 116.

The Act of October 3, 1913 (38 Stat. 114, 166-167—Section II) provided for the deduction "in the case of mines, five per centum of the gross income at the mine of the output for the year for which the computation is made, etc." The amount of the deduction was attacked on the ground it was inadequate. In *Stanton v. Baltic Mining Co.,* 240 U. S. 103, this Court sustained the right of Congress to put an arbitrary limit on the allowance.

The Revenue Act of 1916 (39 Stat. 756, 767) allowed: "In the case of oil and gas wells a reasonable allowance for actual reduction in flow and production * * *; in the case of mines a reasonable allowance for depletion thereof * * *."

The same language was used in the Excess Profits Tax Act of 1917.

The Revenue Act of 1918 (40 Stat. 1057, 1077) allowed (Sec. 234 (a) (9)): "In the case of mines, oil and gas wells, other natural deposits and timber, a reasonable allowance for depletion * * * according to the peculiar conditions in each case * * *". The section also pro-

vided for the computation of the deduction based on "discovery" instead of cost, when the value was materially disproportionate to cost.

The Revenue Acts of 1921 and 1924 contained exactly the same provisions regarding depletion except for certain limitations on "discovery" depletion which are not material here.

The Revenue Act of 1926 (which is applicable here) abolished discovery depletion for oil and gas properties and substituted percentage depletion therefor. Section 204 (c) provided that the basis for depletion should be the same as the basis for gain or loss from a sale, except that in the case of mines discovery value was still permitted, and:

> "(2) In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph."

In other words, taxpayers owning interests in oil and gas properties could still choose between cost, or March 1, 1913 value, and percentage depletion, instead of between cost, or March 1, 1913 value, and discovery depletion.

The principal motive of Congress in making this change was to avoid the administrative difficulties of discovery depletion.[1]

The allowance of percentage depletion in the case of oil

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(1) The Finance Committee Report on the 1926 Act (Senate Report No. 52, 69th Congress, 1st Session) states at page 17:

> "The administration of the discovery provision of existing law in the case of oil and gas wells has been very difficult because of the discovery valuation that had to be made in the case of each discovered well. In the interest of simplicity and certainty in administration your committee recommends etc." To the same effect see "Statement of the Managers on the Part of the House" at page 31 of the Conference Report (House Report No. 356, 69th Congress 1st Session).

and gas wells has been continued in the 1928, 1932 and 1934 Revenue Acts.

Changes resulting from the adoption of percentage depletion.

The abandoning of discovery depletion and the substitution of percentage depletion resulted in two important changes regarding the depletion allowance. In the case of percentage depletion there is no limit to the amount of depletion which can be allowed with respect to any particular property. In other words, there is no basis which, when exhausted, stops the allowance. When depletion is based on cost, March 1, 1913 value, or discovery value, the deduction stops when it aggregates the basis. For example, if the basis is $100,000, whenever a taxpayer has been allowed depletion deductions in the aggregate amount of $100,000 he is entitled to no further allowance, even though the property may continue to produce for many years.

The other important change resulting from the adoption of percentage depletion is that the allowance for depletion is no longer related to, or dependent upon, the actual production from, or the exhaustion of, the property. This is clearly illustrated as follows:

In the case of depletion based upon cost, or other fixed basis, if ten per cent of the oil or gas reserve was extracted in a particular year the taxpayer must be allowed ten per cent of the basis. In the case of percentage depletion the allowance is entirely different.

In Texas in recent years oil has sold for $2.00 or more per barrel, and as low as ten cents per barrel. If in one year ten cents per barrel is paid for the production from a particular property and in another year $2.00 per barrel is paid for oil from the same property, it is apparent that the amount of the depletion allowance is twenty times more dependent upon the price of oil than it is upon the amount of oil produced. As percentage depletion is limited not

only by gross income, but by net income, the allowance, in actual practice, will vary more on account of price than the actual ratio of difference in the price.

For example, assume that the operating expense of a particular property is twenty-five cents a barrel. In one year the property produces 100,000 barrels of oil which was sold for $1. a barrel, or $100,000. As the operating expense was twenty-five cents a barrel the net income was $75,000. The taxpayer would thus be permitted to deduct $27,500 depletion, because that amount is 27½ per cent of the gross income and less than 50 per cent of the net income.

The next year the same property produced 100,000 barrels of oil, which sold for but 30 cents a barrel with the same operating cost, so there was a net income of $5,000. The depletion allowance would be but $2,500 because of the limitation that it should not exceed 50 per cent of the net income. Had the price of oil been 25 cents a barrel there would have been no net income and no allowance for depletion. In each of the cases mentioned the exhaustion of the oil reserves would be identical.

History of the taxation of advance royalties or bonuses.

The foregoing has been devoted to a history of depletion allowances generally. We now direct ourselves to the history of the treatment of advance royalties, or bonuses, received for executing oil and gas leases.

In dealing with cost depletion the Commissioner of Internal Revenue has, since 1918, held that advance royalties, or bonus payments, are subject to depletion. As originally issued Article 215 (a) of Regulations 45 (1918 Act) provided that the bonus "shall be regarded as a return of capital to the lessor, but only to the extent of the capital remaining to be recovered through depletion * * *". By Treasury Decision 3938, promulgated in 1926, (Internal Revenue Bulletin V-2, p. 117) the subdivision just

quoted was changed to read, as all regulations dealing with cost depletion have since read, " * * * there shall be allowed as a depletion deduction in respect of the bonus an amount equal to that proportion of the cost or value of the property * * * which the amount of the bonus bears to the sum of the bonus and the royalties expected to be received * * *". The same Treasury Decision made a similar change in Article 215 (a) of Regulations 62 (1921 Act) and Article 216 (a) of Regulations 65 (1924 Act). Article 216 (a) of Regulations 69 (1926 Act) was similar to the regulations under the prior Acts as amended by Treasury Decision 3938.[1]

All of the Regulations beginning with Regulations 45 under the 1918 Act have provided that if depletion is allowed with respect to an advance royalty and no oil or other mineral is produced by the lessee during the life of the lease, the lessor is required to restore the allowance to his accounts and to report it as income in the year the lease is terminated.[2]

The Regulations under the 1918 Act were questioned by the Board of Tax Appeals which held, in *Murphy Oil Co.*, 15 B. T. A. 1195, that, as a bonus bore no relationship to production, it could not be subject to a depletion deduction. The Circuit Court of Appeals for the Ninth Circuit reversed the Board, 55 F. (2d) 17, and this Court granted certiorari.

Before this Court passed on the Murphy case it disposed of *Burnet v. Harmel*, 287 U. S. 103, in which present counsel contended that a bonus received for executing an oil and gas lease in Texas was taxable as "capital gain" because, under Texas law, the leases conveyed fee title to the minerals in place. In disposing of the case this Court denied the taxpayer's contention largely on the ground that the bonuses involved were advance royalties subject to deple-

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(1) Article 215 (a) of Regulations 45 and Article 216 of the various Regulations, together with the change made by T. D. 3938, are set forth at page 4 of this brief.

(2) The applicable provisions of the Regulations are set forth at page 4 of this brief.

tion. There was no showing in the Harmel case that there was oil upon the property when it was leased or that production was obtained thereon in the same year or later.[1]

The Court in the Harmel case states (P. 111):

> "The Court below thought that the bonus payments, as distinguished from the royalties, should be treated as capital gain, apparently because it assumed that the statute authorizes a depletion allowance upon the royalties alone. See Ferguson v. Commissioner of Internal Revenue (C. C. A. 5th) 45 F. (2) 573, 577. But bonus payments to the lessor have been deemed to be subject to depletion allowances under Section 214(a) (9) Revenue Act of 1924, by Art. 216, Treasury Regulations 65, as well as under earlier acts. Section 214(a) (10), Revenue Act of 1921, Art. 215, Treasury Regulations 62. Cf. Murphy Oil Co. v. Burnet (C. C. A. 9th) 55 F. (2d) 17. The distinction, so far as we are advised, has not been taken in any other case * * *. We see no basis for it."

The Harmel decision was followed shortly thereafter by the decision in *Murphy Oil Co. v. Burnet,* 287 U. S. 299, wherein the question involved was (1) whether a substantial bonus, or advance royalty, paid to a lessor of oil land by his lessee was non-depletable income in its entirety when received, or (2) whether, by an allowance for depletion with respect thereto, the basic depletable value should be reduced, so that, in later years, the allowance for depletion on ordinary royalties, would be based upon such depletable value less the depletion allowable with respect to the advance royalty, instead of upon the full value, as would have been the case if no depletion had been allowable with respect to the advance royalty. This Court said (p. 302) that it was no longer open to doubt that:

> "* * * when the execution of an oil lease is followed by production of oil, the bonus and royalties paid to the

[1] In its brief filed in the Harmel case in this Court the Government argued, without qualification, that the lessor was entitled to depletion on the advance royalty, and therefore, the advance royalty should not be taxed as capital gain.

lessor both involve at least some return of his capital investment in oil in the ground, for which a depletion allowance must be made under Section 234. See Burnet v. Harmel, *supra*. This is obvious where royalties alone are insufficient to return the capital investment. A distinction between royalties and bonus, which would allow a depletion deduction on the former but tax the latter in full as income, when received, *making no provision for a reasonably anticipated production of oil on the leased premises,* would deny the 'reasonable allowance for depletion' which the statute provides. * * * Doubts, if any, whether the statute authorizes depletion of bonus payments have been definitely set at rest by the repeated re-enactment, without substantial changes, of the provisions of Sec. 234(a)(9) since the promulgation of treasury regulations providing for such depletion. * * * In addition, provision is made by subdivisions (c) and (d) of the Regulations, as amended, for such necessary capital readjustments as may be occasioned by the termination, abandonment or expiration of the lease before all the oil is extracted."[1]

The rule was reiterated in *Palmer v. Bender,* 287 U. S. 551, wherein the Court stated "Thus we have recently held that the lessor is entitled to a depletion allowance on bonus and royalties" (p. 557).

The Bureau of Internal Revenue apparently endeavoring to follow this Court's ruling in the Murphy case, on January 16, 1933, promulgated General Counsel's Memorandum 11384 (Internal Revenue Bulletin XII-1 Page 64) in which the possible situations which could arise were divided into four classifications as follows:

(1) No oil being produced when the bonus was received, but future production practically assured because of near-by wells and geological indications.

[1] In the *Murphy* case, the fact that oil was produced from the property during the year the bonus was collected and subsequent thereto was fortuitous, and this Court does not appear to have placed any weight on this fact. It seems clear that this Court's decision in the *Murphy* case would have been the same if the bonus or advance royalty had been collected the last moment of the tax year so that there could be no production, and, therefore, no actual depletion of oil reserves in that year.

(2) No oil being produced when the bonus was received, but property became productive within the taxable year.

(3) No oil being produced when the bonus was received, and not more than a speculative prospect of future oil production at that time, but property is now known to have become productive after the taxable year.

(4) Property has never become productive.

The ruling held that percentage depletion would be allowed in situations (1) and (2), but denied in situations (3) and (4).

The difficulties of administration of G.C.M. 11384 are immediately apparent. Taxpayers would be compelled to employ expensive experts to prove to the Government experts that when the leases were signed production was "practically assured" and disprove that there was "not more than a speculative prospect of future production." One of the reasons for the adoption, in the 1926 Act, of percentage depletion, in lieu of discovery depletion, was to simplify administration and avoid such battles of experts.

Furthermore the requirements of G. C. M. 11384 are discriminatory and unfair. Under it the deduction for depletion with respect to a bonus can be dependent upon the time of the year a lease is made, upon the time necessary to drill a well, or the diligence of the lessee.

Suppose that, at the beginning of 1926, adjoining farms, as to which the prospects for finding oil were substantially equal, were owned by Jones and Smith. Neither farm met the requirement of "production practically assured because of nearby wells and geological conditions." Early in the year Jones leased his farm and received $10,000 bonus. His lessee immediately moved on the property and, notwithstanding the opinion of geologists, secured production on December 31, 1926, which was within the calendar year.

Under the G. C. M. he is entitled to depletion, so paid tax on but $7,250 of the bonus.

Smith started negotiations for a lease on his farm at the same time as Jones, but due to some delay on account of his abstract, or the like, was unable to actually execute the lease until later in the year. His lessee was diligent, but, despite every effort, was unable to complete the well and secure production until January 1, 1927, which was in the year following the receipt of the bonus. Under the G. C. M. Smith is not entitled to any depletion on the bonus, so must pay tax on $10,000.

We submit that no one can find any support for such theory in the law, the Regulations or the decisions of the Courts.

The Board of Tax Appeals on April 26, 1933, decided the case of *Lizzie H. Glide,* 27 B. T. A. 1264 (now pending in the Ninth Circuit) in which the taxpayer contended she was entitled to depletion on a bonus. The Board admitted that bonuses were advance royalties, but held that, unless there was production within the same year as the bonuses were received, there could be no deduction for depletion. The decision mentioned G. C. M. 11384 but held that as the facts presented did not come within the conditions under which depletion would be allowed under the G. C. M. the Board would not pass on it. The dissenting opinion of Board Member Van Fossan, Lansdon and Leech concurring, in the Glide case, is printed in the appendix to this brief at page 31.

The majority opinion in the Glide case apparently denies the deduction because the statute allows depletion in the case of "oil and gas wells", and cites with approval I. T. 2384 (Internal Revenue Bulletin VI-2 page 22) which held:

> "It will be noted that the above quoted section of the law operates only in cases of oil and gas wells and that the allowance for depletion at the rate therein provided is expressly limited to the gross income from

> such property. Accordingly it must be concluded that the application of Article 216 (e) of Regulations 69 is dependent upon whether or not the lease in question is of an oil or gas well, and that Article 216 (e) of the regulation does not apply to leases covering property on which no well is in existence."

The phrase "in the case of oil and gas wells" in the 1926 Act is identical with that in all earlier acts under which the allowance was made on bonuses regardless of whether or not there was a well. No attempt was made, either in I. T. 2384, or in the Glide decision, to explain why the phrase meant one thing in the Acts of 1918, 1921 and 1924 and something else in the Act of 1926. Likewise no attempt is made to explain the fact that before, contemporaneously with, and after the issuance of the I. T. the Bureau continued to allow depletion based on cost or March 1, 1913, value, irrespective of a well.[1] This Court, however, settled the question. In *United States v. Dakota-Montana Oil Co.*, 288 U. S. 459, it was contended that, because of the advent of percentage depletion, the phrase "in the case of oil and gas wells" meant something different from what it had meant in earlier Acts. At page 467 the Court states:

> "There is no ground for supposing that Congress, by providing a new method for computing the allowance for depletion intended to break with the past and narrow the function of that allowance. The reasonable inference is that it did not and that depletion includes under the 1926 Act precisely what it included under the earlier acts."

On June 29, 1934, the Board decided the case of *J. T. Sneed, Jr.*, 30 B. T. A. Advance Sheet No. 171, wherein it appeared that in a year prior to the receipt of the bonuses a gas well had been drilled, but it did not produce commercially until later years because of lack of pipe line facilities.

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(1) The later ruling of the Bureau of Internal Revenue in G. C. M. 11384 had the effect of overruling I. T. 2384 because it permitted percentage depletion where there was no well on the property.

No wells were completed in the years the bonuses were received, but when the case was tried there were fifteen or twenty wells on the property. The Board found that when the bonuses were received production was practically assured and, therefore, the case came squarely within the provisions of G. C. M. 11384 which permitted a depletion deduction on account of the bonus payment. The Board, however, refused to follow the G. C. M. and held the lessor was not entitled to depletion on the bonus because of the absence of production, with two members dissenting "for the reasons so ably set forth by Judge Sibley" in the case at bar.

The Board's memorandum opinion in the case at bar merely found that the bonus payments were received in 1926 and that there was no production on the property until 1930. The case was disposed of on the authority of the *Lizzie H. Glide case,* 27 B. T. A. 1264 because there was "no production during the taxable year before us, nor was there at that time more than a speculative possibility of production."

If the opinions below are affirmed the present petitioners will never secure a depletion allowance on account of the advance royalties received in 1926, although their property is now producing commercially under the leases granted in that year. It is, of course, understood that the allowance for depletion based upon a percentage of income from the property can never be made as to the royalty collected in advance unless made in the year in which the advance royalty is collected. If the lessor had developed the property himself, or leased without advance royalty, but with a larger ordinary royalty, he would have been allowed depletion on all his royalties when received. The Court below denied the depletion allowance, which the taxpayer must have to place him on equal footing with others similarly situated, from a practical standpoint, solely because of the fortuitous circumstances that the oil was developed

by a lessee, who chose to begin operations in a later year, even though had development not been successful, and had no "actual depletion" occurred, the allowance would have been restored to income and taxed in the year this possibility materialized.[1] In order to secure the depletion allowance, Herring in this case, must look alone to the production of oil, but the allowance looks forward or backward to actual production.[2]

The controlling statute here expressly required the allowances for depletion to "be equitably apportioned between the lessor and lessee." (Sec. 214 (a) (9) Rev. Act of 1926.)

The allowance for depletion of the type here involved is predicated primarily upon income. The allowance is 27½% of the gross income, but not more than 50% of the net income, from the property each year. Considered with the Regulations heretofore quoted, it plainly appears that the allowance depends upon receipts more than actual exhaustion of oil or gas reserves, and that, if the allowance be not made as the receipts come in and are taxed, the Congressional intention of allowing, over the life of the property to every one having an economic interest in the property, 27½% of their respective gross incomes therefrom, cannot be carried out. On the other hand, if the allowance is made as royalties are received, any allowance not followed by actual depletion through production can be recovered and taxed by the terms of the Regulation heretofore quoted.

The majority below in the case at bar held that a lessor

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(1) Article 216 of Regulations 69 provides: "(c) If for any reason any such mineral lease shall be terminated or abandoned before the mineral which has been paid for in advance has been extracted and removed, and the lessor repossesses the leased property, the lessor shall adjust his capital accounts by restoring to the capital sum of the property the depletion deductions made in prior years on account of royalties on mineral paid for but not removed, and his income account shall be adjusted so as to include the amount so restored to capital sum as income of the year such lease is terminated or the property repossessed, and the tax thereon paid."

(2) See Judge Sibley's dissenting opinion in this case, R. 42, and page 27 this brief.

was not entitled to the statutory allowance for depletion with respect to advance royalties unless oil or gas was actually produced from the property during the tax year in which the advance royalties or bonus was received:

> "The depletion charge permitted as a deduction from gross income in determining taxable income 'in the case of oil and gas wells' represents the reduction, during the taxable year in question, of oil or gas in place in land in which the taxpayer has an interest. Helvering v. Falk, U. S. Sup. Ct., Jan. 15, 1934; U. S. v. Ludey, 274 U. S. 295, 302. No statutory provision which has come to our notice authorizes such a deduction to be based on an expectation, however well founded, that oil or gas remaining in place in land during the taxable year in question will be extracted in subsequent years. Depletion of oil or gas is a result of the production and sale thereof. Palmer v. Bender, 287 U. S. 551, 558." (R. 42.)

The majority opinion takes no notice of the fact that an allowance for "percentage" depletion can only be taken as to advance royalties in the year the royalties are taxed; and that in cases where "percentage" depletion is not applied, the allowance with respect to the bonus or advance royalty *will not* be made in any other year; and that, in neither case, can subsequent allowances be increased on account of the fact that no depletion was allowed on the advance royalty.[1] Nor does it refer to the fact that, if depletion is allowed with respect to an advance royalty, and no oil or other mineral is produced by the lessee during the life of the lease, the lessor is required to restore the allowance to his accounts and to report it as income in the year the lease is terminated.[2]

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[1] As pointed out earlier in this brief "percentage" depletion, first introduced in the 1926 Revenue Act, is unique in that the total allowances to be made over the life of the property are not limited to any particular cost or basis. Under the alternate system in the 1926 law, and the only one in earlier acts since 1918, when the total allowances equalled the basis or cost, no more was allowable. "Percentage" depletion allowances are unlimited in that respect. It is therefore impossible to make up for the denial of the allowance on a bonus in a later year.

[2] Regulations 69, Art. 216(a) *supra*.

The opinion of the majority below indicates a misunderstanding of the Murphy decision. After reciting that oil was extracted in 1919 and 1920 it cites the Murphy case as holding that "the depletion charge permitted as a deduction from gross income in determining taxable income 'in case of oil and gas wells' represents the reduction, during the taxable year in question, of oil or gas in place in land in which the taxpayer has an interest" (R. 42). The fact is that the leases in the Murphy case were made in 1913 and the bonuses were all paid prior to 1919. The question was whether the bonuses should be considered in their entirety as income when received, or if they should be treated as advance royalties and be reduced by a depletion allowance, and thus reduce the basis for the depletion allowance on income from production in later years. This Court held that allowable depletion must be deducted from the bonus in the year the bonus was received and the depletable base reduced accordingly. In other words, the decision holds that a part of the depletion deduction allowable on account of 1919 and 1920 production must be taken in the years the bonuses were received, irrespective of the actual depletion in those years. This means that the 1919 and 1920 allowance was not, as the majority below states, in step with actual depletion, but was less than the actual depletion incurred in those years, because a portion of the allowance was properly attributable to the prior years in which the bonuses were paid.

As this brief repeatedly states the allowance permitted by the statute follows income and looks forward or backward to actual depletion, and such has always been, and now is, the practice. For instance, payment for "oil runs" is ordinarily made in the month following the run. In computing depletion the Bureau of Internal Revenue consistently holds that the depletion allowance for December of any year is not allowable in the year in which the actual depletion occurs but in the following year when the income from the oil is received.

A further illustration of the misconception of the problem by the majority below is the statement (R. 41) that "It was suggested in argument that, by reason of Petitioner's receipt in that year of the large sum in bonuses, depletion allowances made in that year probably would be more beneficial to Petitioner than such allowances made in later years were likely to be". As appears quite obvious nothing that is done with respect to the allowance in the year here involved will have any effect on subsequent years. In later years the allowance will be 27½ per cent of the income from the property in those years.

Petitioners' view that the majority opinion below is in conflict with the decisions of this Court heretofore mentioned is reinforced by the similar view of the minority below. Judge Sibley, in dissenting said:

> "Both (bonuses and ordinary royalties) are equally income to the lessor from his land, and both are alike subject to be reduced by allowance for depletion. Burnet v. Harmel, 287 U. S. 103; Murphy Oil Company v. Burnet, 287 U. S. 299; Bankers Coal Co. v. Burnet, 287 U. S. 309, Palmer v. Bender, 287 U. S. 551. The income tax statutes have studiously endeavored to tax net income only, and to make just allowances for expenses and for a return of capital lost in producing it. The statute in question nowhere says that the depletion allowance commanded is to be taken when the oil is extracted, but the general provision has always been that a *reasonable* allowance shall be made *according to the peculiar conditions in each case.* Construing it as to a bonus, it is said in Murphy Oil Company v. Burnet, *supra,* at page 307: 'Here an anticipated depletion of capital is to be returned from bonus and future royalties to the extent the applicable statutes allow, and the problem is to allocate such *anticipated depletion* to a payment made in *advance of its occurrence.*' * * * If the tax officer treats a bonus payment as income, he must deplete it 27½% under the command of the statute." (R. 45 and p. 27 this brief)

The question should be considered in the light of well-known practical facts. Among these are the following:

It is most unusual for an oil and gas lease to be made on a tract of land already producing. Such leases ordinarily are the means by which the landowner secures the exploration of his property for oil or gas, and its discovery, as well as its development and exploitation. It is the custom for "ordinary royalties" to be the same in any territory, regardless of differences in the prospect of securing oil or gas on various tracts. This difference is ordinarily adjusted in commercial transactions by the amount of the advance royalty or bonus. Cf. *Work v. Mosier,* 261 U. S. 352.

The Treasury Regulations which, from 1918 to 1926, have expressly provided for depletion with respect to bonuses or advance royalties (See Murphy Oil Company v. Burnet, *supra*) never made any distinction whatsoever because one property might be producing when leased and another undeveloped, or because production might be secured in the year the lease was made on one and not until later on another. But these practical facts must have been known to the authors of these Regulations.

It is equally well known that, in the case of most oil and gas leases (including those involved in this case), the lessor cannot control the time development is begun. It can ordinarily be delayed by the payment of nominal rentals during the entire primary term of the lease. Likewise, the length of time for drilling a well varies, because of depth and geological conditions, from a few days to several months.

It is difficult to believe that this Court will hold that past practice is to be disregarded and the regulation applied only in the most unusual case (*i. e.,* in the case of the leasing of a property already producing), when that limitation is not plainly expressed.

A regulation which would grant an allowance for depletion equal to 27½% of over $680,000. of advance royalties,

if one or two hundred barrels of oil, worth, perhaps, $100.00 or $200.00 had been produced in the year of leasing, and deny the allowance if no production is secured until the next year, is arbitrary and capricious. The same is true of a regulation which would grant the allowance if one lessor grants his lease early in his tax year so that a well can be, and is, completed within that year, but denies it to a neighbor similarly situated, who leases so late in the year that his equally diligent lessee cannot secure actual production until the next year.

A further illustration of the inconsistency of the holding below is shown by the following quotation from Judge Sibley's dissenting opinion, wherein he states (R. 44 and p. 27 this brief):

> "If not a constitutional necessity, it is certainly more reasonable, where income is produced by a commercial depletion, to deduct the depletion from the particular income produced by it as an element of cost rather than to make it an offset against general income in some other year. If for example the owner of timber leases it to a sawmiller to be exhausted over a term of years and is paid as the timber is cut, the actual depletion of his timber by cutting corresponds with his receipt of income and no problem is presented. But if the sawmiller should pay for all after the end of the term, it would be unreasonable to allow the owner depletion in the years the timber was cut when he had no income and no tax to pay, and to tax his whole income without any depletion at the end. So if the whole timber should be paid for in advance. Again, if the timber owner is cutting and selling his own timber, he should be allowed to deduct the value of his timber from the income as received, no matter when the trees were cut or delivered. Although oil and gas are underground and timber is not, both are by the statute depletable and the same principle applies. The bonus on an oil and gas lease is so far as authority can make it merely royalties paid in advance, and both bonus and royalties are the consideration for the oil expected to be recovered by the lessee."

The Court is referred to the dissenting opinion below (R. 42 and p. 27 this brief), as well as the dissenting opinion in the Glide case (p. 31 this brief), for a more extended discussion of such inconsistencies.

Conclusion.

As the decisions of this Court have established that a deduction for depletion is allowable on advance royalties; as Treasury Regulations have, since 1918, consistently allowed the same deduction; as Congress has repeatedly reenacted the depletion sections in the same language and in the light of the Treasury Regulations mentioned, and, as the rule of the opinion below is discriminatory, unfair, and ignores the practical aspects of the problem, the decision below should be reversed.

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APPENDIX.

Dissenting Opinion of Judge Sibley in Herring Case.

"SIBLEY, Circuit Judge, Dissenting:

"The question is whether a percentage depletion is allowable on bonuses received in 1926 for oil and gas leases which are to endure so long as oil or gas is produced when no well was drilled and no oil produced under them during that year, although the oil and gas were present and were produced later. The Board of Tax Appeals denied the allowance because there was no well, and this court denies it because no oil was taken out. One of the pertinent provisions of the Revenue Act of 1926, 'In computing net income there shall be allowed a deduction . . . in the case of mines, oil and gas wells, and other mineral deposits and timber, a reasonable allowance for depletion and for depreciation of improvements according to the peculiar conditions in each case,' occurred in previous acts. The other provision: 'In case of oil and gas wells the allowance for depletion shall be 27½ percentum of the gross income from the property during the taxable year,' is new. Great difficulty was found under the former provision in estimating the content of an oil and gas reserve under the ground and in arriving at what proportion of it was represented by the operations of a particular taxable year, and also in fixing the value of the reserve under the rules relating to discovery value. To avoid these difficulties Congress in the new provision ignored both the size and the value of the reserve, assumed that the value of any production of oil or gas would on the average be 27½ per cent original capital investment not to be taxed, and the remaining 62½ per cent would be taxable income, and provided for its taxation in the year it was received. It is evident that the 27½ per cent deduction which the statute not only permits but commands must be made in the year that the income which measures it is re-

ceived and taxed, that it cannot be taken any subsequent year, and that it is entirely independent of actual depletion, being so named because it looks forward or backward to the exhaustion represented by the income received. The purpose and command of the provision is defeated by the decision in this case. The oil and gas were present to be produced, as was of course supposed when nearly a half-million dollars were paid in advance for them as bonuses, and as was proven when the wells were drilled. That the lessees by their own choice not to drill the first year should control the taxability of the lessor's bonuses, or that the depletion allowance on the entire bonuses should depend on the production in the taxable year of a few gallons of oil or a few feet of gas seems to me both unreasonable under the general provision for depletion and in contradiction of the special provision for the percentage deduction.

"It is true that depletion, like depreciation because of wear and tear and obsolescence, is based on the actual gradual loss of capital. The allowance for wear and tear and obsolescence is, however, always estimated and distributed over the useful life of the property considered, and does not depend on a demonstration of what actually happened to it in the particular taxable year. The allowance for them is a general offset against all income for the taxable year rather than a deduction from some particular item of income, because wear and tear and obsolescence, although a loss of capital, do not directly produce any particular income. Depletion also may sometimes be a mere loss, as when oil or gas runs to waste or standing timber dies and rots. But ordinarily depletion refers to a commercial use of part of a reserved store, as where ore or gas or oil is extracted for sale, or timber or ore or oil is manufactured into lumber or metal or gasoline and sold. In such cases the capital represented by the depletion is used directly to produce income and is converted into it.

According to *Eisner v. McComber,* 252 U. S. 189, only gain is taxable income under the Sixteenth Amendment where a conversion of property is involved. Congress is therefore merely staying on safe constitutional ground in providing for this percentage depletion against income received from oil and gas. If not a constitutional necessity, it is certainly more reasonable, where income is produced by a commercial depletion, to deduct the depletion from the particular income produced by it as an element of cost rather than to make it an offset against general income in some other year. If for example the owner of timber leases it to a sawmiller to be exhausted over a term of years and is paid as the timber is cut, the actual depletion of his timber by cutting corresponds with his receipt of income and no problem is presented. But if the sawmiller should pay for all after the end of the term, it would be unreasonable to allow the owner depletion in the years the timber was cut when he had no income and no tax to pay, and to tax his whole income without any depletion at the end. So if the whole timber should be paid for in advance. Again, if the timber owner is cutting and selling his own timbers he should be allowed to deduct the value of his timber from the income as received, no matter when the trees were cut or delivered. Although oil and gas are underground and timber is not, both are by the statute depletable and the same principle applies. The bonus on an oil and gas lease is so far as authority can make it merely royalties paid in advance, and both bonus and royalties are the consideration for the oil expected to be recovered by the lessee. Both are equally income to the lessor from his land, and both are alike subject to be reduced by allowance for depletion. *Burnet v. Harmel,* 287 U. S. 103; *Murphy Oil Co. v. Burnet,* 287 U. S. 299; *Bankers Coal Co. v. Burnet,* 287 U. S. 309; *Palmer v. Bender,* 287 U. S. 551. The income tax statutes have studiously en-

deavored to tax net income only, and to make just allowances for expenses and for a return of capital lost in producing it. The statute in question nowhere says that the depletion allowance commanded is to be taken when the oil is extracted, but the general provision has always been that a *reasonable* allowance shall be made *according to the peculiar conditions of each case.* Construing it as to a bonus, it is said in *Murphy Oil Co. v. Burnet, supra,* at page 307: 'Here an *anticipated* depletion of capital is to be returned from bonus and future royalties to the extent the applicable statutes allow, and the problem is to allocate such *anticipated depletion* to a payment made in *advance of its occurrence.* The allocation is permitted by statute.' This language is quite at variance with that of the court below quoted in the majority opinion. When this provision was first enacted in 1918, Regulation 45, Art. 215 (d), provided that on the expiration or abandonment of a lease *without the removal* of any or all of the mineral contemplated by the lease, there must be a return to capital account of so much of the *bonus* deducted from the recoverable capital as *exceeds actual depletion,* and that amount must be treated as income the year the lease was ended. This shows that it was understood that the bonus payment was considered depletable in advance of actual depletion and that if the contemplated depletion does not occur the correction is to be made at the end of the lease. The same Regulation has been continued ever since, as Congress has reenacted the same depletion provision, and it is referred to and its operation approved in *Murphy Oil Co. v. Burnet, supra,* at page 304, and again at page 306. The statutory words: 'In case of oil and gas wells' are directly connected with 'or other mineral deposits.' Wells as such were not in the mind of Congress as subjects of depletion, but the deposits of oil and gas and other minerals were in mind,

and as shown above, depletion of bonuses on leases was regularly allowed although in most cases, no doubt, actual production is not accomplished in the year the lease is made. When in the Act of 1926 Congress again used the expression, 'In case of oil and gas wells' in connection with the percentage depletion no narrower meaning is to be attributed to it. *United States v. Dakota-Montana Oil Co.*, 288 U. S. 459. On the contrary, even more plainly the receipt of income and not the existence of a well or of production from it is made the generating cause of the depletion allowance. If the tax officer treats a bonus payment as income he must deplete it 27½ per cent under the command of the statute.

"In *Helvering v. Falk*, .. U. S. .., depletion under all the Acts through that of 1926 was under consideration and the cases were reviewed with this conclusion: 'Whatever may be said concerning the power of Congress to treat the entire proceeds of a mine as income, obviously the statute has not undertaken to do so. The plain purpose we think was to tax only that portion of the proceeds remaining after proper allowance for depletion. This allowance represents property consumed, is treated as if capital assets, and no tax is laid upon it. The statute must be so applied in practice as to carry out this purpose.' The judgment in the case at bar defeats the statutory purpose and by denying the allowance which the statute commands taxes that part of the money received which ought to be treated as if capital assets."

Dissenting Opinion in Lizzie H. Glide Case.

"VAN FOSSAN, dissenting: I find it necessary to dissent from the decision of the majority. In considering the

right of a taxpayer to depletion, I am unwilling to decide the question on any basis so highly technical and artificial as that employed in the prevailing opinion. Under the reasoning of the majority, the right to depletion depends on the existence of a well on the property. Obviously the production of the well, provided there be a well, need bear no relation to the amount of depletion. The law allows a flat percentage of income from the property (not from the well) as depletion. The Supreme Court has held that a bonus is income. Therefore if the bonus be paid and there happens to be a well in existence (however inconsequential the production) the taxpayer gets full statutory depletion. If there be no well, regardless of other conditions, the taxpayer gets no depletion. But assume a case where, as frequently happens, a bonus is paid in one year and there is no well completed until the next year. The taxpayer would get no depletion on account of the bonus (or advance royalties, as the Supreme Court has called them) because there was no well on the property though all surrounding property bore productive wells, nor would he get depletion of the bonus in the next year even if a producing well be completed, because the bonus was not income in that year. Variations of this illustration, emphasizing the absurdities of the situation, could easily be multiplied.

"I am unable to see any defensble basis for a distinction that would produce such an inequitable and illogical result. The prevailing opinion introduces a new concept into the theory of depletion and in many cases sets at naught the intention of Congress as interpreted by the decisions of the Supreme Court so far as depletion of bonuses is concerned. *Murphy Oil Co. v. Burnet,* 287 U. S. 299. The cited case clearly decides that a bonus is depletable and makes no suggestion that this right should be governed by

such a rule as laid down by the majority. The court clearly suggests the opposite:

> "A distinction between royalties and bonus, which would allow a depletion deduction on the former but tax the latter in full as income, when received, making no provision for *a reasonably anticipated production of oil* on the leased premises would deny the 'reasonable allowance for depletion' which the statute provides. * * * (Italics supplied.)

"Moreover, I further find myself in disagreement with the majority opinion in the summary manner in which G.C.M. 11384 is disposed of. That the Commissioner is not now contending for such a rule as proposed by the majority is clear from this memorandum, which provides that depletion should be allowed if future production is practically assured because of nearby wells and geological indications. Whether this interpretation is too narrow it is not necessary to discuss, but certainly it is broad enough to cover the instant case. The facts show that oil was being produced in the same township and in the same oil field. This brings the petitioner squarely within the first of the four situations referred to in the memorandum. The prevailing opinion dismisses the matter on the basis of failure of proof.

"In my opinion the majority of the Board throughout this opinion have grasped at a shadow of diction and allowed the substance of the thought and intention of Congress and the Supreme Court to escape them.

"Lansdon and Leech agree with this dissent."